Prudential Standard LPS 112

Capital Adequacy: Measurement of Capital

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that life companies maintain adequate levels of high quality capital. This Prudential Standard forms part of a comprehensive set of prudential standards that deal with the measurement of the capital adequacy of a life company.

The key requirements of this Prudential Standard are that a life company must:

- include only instruments that meet the criteria in this Prudential Standard in its capital base and the capital base of each of its funds;
- make certain regulatory adjustments to its capital base and the capital base of each of its funds; and
- meet the minimum levels set out in this Prudential Standard with respect to the types of capital used to meet the Prudential Capital Requirement of the life company and each of its funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. Aa life company must apply this Prudential Standard separately to:

   (a) for a life company other than a friendly society: each of its statutory funds, its shareholders' fund and the life company as a whole; and

   (b) for a friendly society: each of its benefit fund, its management fund and the friendly society as a whole.

4. This Prudential Standard only applies to the business of an Eligible Foreign Life Insurance Company (**EFLIC**) which is carried on through its Australian statutory funds but not otherwise.[2]

5. Subject to any specific transition rules, this Prudential Standard applies to life companies from 1 January 2013 (effective date).

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

7. Unless otherwise indicated:

   (a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or a benefit fund of a friendly society, as relevant;

   (b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and

   (c) the term **fund** will be used to refer to a statutory fund or a general fund, as relevant.

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[1] Refer to subsection 21(1) of the Act.

[2] Refer to section 16ZD of the Act.

8. For the purposes of this Prudential Standard:

   (a) a **component of capital** is any form of capital defined in this Prudential Standard as eligible for inclusion in **Tier 1 capital** or **Tier 2 capital**;

   (b) a **category of capital** is a group of components of capital, namely: **Common Equity Tier 1 capital**, **Additional Tier 1 capital** and Tier 2 capital, as appropriate;

   (c) **associates** is a reference to associates as defined in the **Australian Accounting Standards** and is to be read as also applying to joint ventures unless otherwise indicated; and

   (d) **the earnings or retained earnings of a life company** is a reference to the earnings or retained earnings of the life company determined under the life company's prudential reporting to APRA under the *Financial Sector (Collection of Data) Act 2001* (**Collection of Data Act**).

   (e) **the net assets of a statutory fund or general fund** is a reference to the net assets of the fund determined under the life company's prudential reporting to APRA under the Collection of Data Act. It includes shareholders' capital and retained profits, unallocated benefit fund reserves, other reserves and foreign currency translations.

Capital base of a life company

9. The **capital base** must be assessed for a life company as a whole and for each of its funds. The requirements for statutory funds are specified in the section starting at paragraph 32. The requirements for general funds are specified in the section starting at paragraph 35. The following paragraphs set out the requirements at company level.

10. The capital base of a life company consists of the sum of the following elements:

    (a) Tier 1 Capital comprising:

       (i) Common Equity Tier 1 capital; and

       (ii) Additional Tier 1 capital;

       and

    (b) Tier 2 capital.

11. A life company must ensure that at all times:

    (a) the Common Equity Tier 1 capital for the life company exceeds 70 per cent of the **Prudential Capital Requirement** (PCR) of the life company;

    (b) the Tier 1 capital for the life company exceeds 80 per cent of the PCR of the life company; and

    (c) the capital base for the life company exceeds the PCR of the life company.

    APRA may, in writing, set higher limits for Common Equity Tier 1 capital and/or Tier 1 capital for a life company.

12. A life company must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements of this Prudential Standard for the particular category of capital in which it is included. A life company must not incorporate a component of capital as part of its capital base where that component does not meet, or is inconsistent with, the requirements of this Prudential Standard.

13. A life company must not include a component of capital in a particular category of capital base if that component, when considered in conjunction with other related transactions that affect its overall economic substance, could be reasonably considered not to satisfy fully the requirements of this Prudential Standard for components of that category of capital.

14. A life company must not assign a capital instrument to a particular category of capital based on a future event, such as the future sale or issuance of a higher quality capital instrument, until such time as:

    (a) the future event occurs;

    (b) the future sale or conversion has taken place and is unconditional and cannot be reversed; and

    (c) the proceeds have been received by the company.

15. A life company must:

    (a) provide APRA, as soon as practicable, with copies of documentation associated with the issue of all capital instruments included in the capital base; and

    (b) where the terms of the instrument depart from established precedent:

        (i) consult with APRA on the eligibility of the instrument for inclusion in its capital base in advance of the issuance of the capital instrument; and

        (ii) provide APRA with all information it requires to assess the eligibility of the capital instrument.

16. APRA may, in writing, require a life company to:

    (a) exclude from its capital base any component of capital that APRA has reasonable grounds to believe does not represent a genuine contribution to the financial strength of the company; or

    (b) reallocate to a lower category of capital a component of capital where APRA has reasonable grounds to believe that it does not fully satisfy the requirements of this Prudential Standard for the category to which it was allocated by the life company.

Tier 1 capital

17. For the purposes of calculating a life company's capital base, Tier 1 capital comprises:

    (a) Common Equity Tier 1 capital; and

    (b) Additional Tier 1 capital.

Common Equity Tier 1 capital

18. Common Equity Tier 1 capital comprises the highest quality capital that fully satisfies all of the following essential characteristics:

    (a) is subordinated to all other elements of funding;

    (b) absorbs losses as and when they occur;

    (c) has full flexibility of dividend payments; and

    (d) has no maturity date.

19. Common Equity Tier 1 capital consists of the sum of:

    (a) paid-up ordinary shares issued by the life company that meet the criteria for classification as ordinary shares for regulatory purposes (refer to Attachment A);

    (b) retained earnings, including interim profit or loss;

    (c) current year earnings;

    (d) accumulated other comprehensive income and other disclosed reserves[3]; and

    (e) regulatory adjustments applied in the calculation of Common Equity Tier 1 capital.

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[3] Includes unallocated surplus in friendly society benefit funds that can be transferred to the management fund.

Additional Tier 1 capital

20. Additional Tier 1 capital consists of the sum of:

    (a) equity capital instruments issued by the life company that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1 capital) (refer to Attachment B); and

    (b) regulatory adjustments applied in the calculation of Additional Tier 1 capital.

Tier 2 capital

21. Tier 2 capital consists of the sum of:

    (a) instruments issued by the life company that meet the criteria for inclusion in Tier 2 capital set out in Attachment C; and

    (b) regulatory adjustments applied in the calculation of Tier 2 capital.

Loss absorbency of capital at the point of non-viability

22. To be eligible for inclusion in Additional Tier 1 or Tier 2 capital, an instrument must include in its terms and conditions:

    (a) a provision that, on the occurrence of a trigger event, the liabilities of the life company will cease under the instrument (the instrument will be written-off); or

    (b) a provision that, on the occurrence of a trigger event, the instrument will be converted into listed ordinary shares (subject to paragraph 24).

23. For the purposes of paragraph 22, a trigger event is the earlier of:

    (a) a decision that a write-off (or, where applicable, conversion), without which the life company would become non-viable, is necessary, as determined by APRA and notified to the life company in writing; and

    (b) a decision to make a public sector injection of capital, or equivalent support, without which the institution would have become non-viable, as determined by APRA.

24. A life company including conversion terms under subparagraph 22(b) must:

    (a) be satisfied there are no legal or other impediments to issuing the relevant number of shares to effect conversion and all authorisations have been obtained;

    (b) ensure the instrument meets the following criteria:

        (i) conversion must be to listed ordinary shares of the insurer or a parent entity;

        (ii) the conversion formula for determining the number of ordinary shares received upon conversion of the instrument must be fixed in the issue documentation and must include a cap on the maximum number of ordinary shares that holders will receive on conversion; and

        (iii) the maximum number of ordinary shares received upon conversion must not exceed the price of the instrument at the time of issue divided by 20 per cent of the price of an ordinary share at the time of issue of the instrument. For these purposes, in calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits.

Regulatory adjustments to Common Equity Tier 1 capital

25. For the purpose of calculating its capital base, a life company must adjust Common Equity Tier 1 capital by making the following deductions:

    (a) goodwill and any other intangible assets, net of adjustments to profit or loss, reflecting any changes arising from impairment of goodwill[4];

    (b) deferred tax assets net of deferred tax liabilities[5];

    (c) any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which the life company is an employer-sponsor, unless otherwise approved, in writing, by APRA. Any excluded surplus must reverse any associated deferred tax liability from Common Equity Tier 1 capital;

    (d) any deficit in a defined benefit superannuation fund of which the life company is an employer-sponsor and that is not already reflected in Common Equity Tier 1 capital;

    (e) all holdings of own Common Equity Tier 1 capital instruments;

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[4] This includes that component of investments in controlled entities which represents goodwill and any other intangible assets (i.e. current value less value of identifiable net tangible assets).

[5] Where the amount of deferred tax liabilities exceeds the amount of deferred tax assets, the excess cannot be added to Tier 1 capital (i.e. the net deduction is zero). Deferred tax assets and liabilities include any tax effects that would result from adjustments to policy liabilities. This item excludes any amounts associated with surpluses in any life company employer-sponsored superannuation funds.

(f) unrealised fair value gains (or, where applicable, adding back unrealised fair value losses) arising from changes in a life company's or a fund's own creditworthiness;

(g) all reinsurance assets[6] (if positive) reported in relation to each reinsurance arrangement that, subject to a 6 month grace period from risk inception, does not comprise an executed and legally binding contract;

(h) the component of an investment in a subsidiary, associate or joint venture that is required to meet regulatory capital requirements of that subsidiary, associate or joint venture[7];

(i) assets that are under a fixed or floating charge[8] or other security, to the extent of the indebtedness secured on those assets;

(j) the difference between the **adjusted policy liabilities** and the **policy liabilities** disclosed in the **statutory accounts** together with any tax effects that would result from these adjustments. This difference can be positive or negative. Policy liabilities must be net of reinsurance. The method of determining the adjusted policy liabilities is specified in Attachment D;

(k) the difference between fair value and reported value of assets. This deduction can be a negative amount if fair value exceeds reported value.

26. For the purposes of paragraphs 25(a) and 25(h), deductions only need to be made in respect of entities that are subject to prudential capital requirements, or that are operationally dependent or undertake insurance-related business, including brokers, agents, servicing or management companies.

27. For the purposes of paragraph 25(b), deferred tax assets can only be netted against deferred tax liabilities where the tax assets and tax liabilities are levied by the same authority and the authority allows netting when the taxes are paid.

28. For the purposes of paragraph 25(c), a life company may make representations to APRA to include a surplus as an asset (and hence include the surplus in Tier 1 capital) where the life company that is the employer-sponsor is able to demonstrate unequivocal and unrestricted access to a fund surplus in a timely manner. Where APRA is satisfied regarding such access, a life company may include the surplus in its assets. This surplus will no longer be required to be deducted from Common Equity Tier 1 capital.

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[6] For the purposes of this Prudential Standard, 'reinsurance assets' refers to reinsurance assets net of doubtful debts.

[7] This only applies to the remaining component of the investment after intangible amounts have been deducted from the capital base as specified in paragraph 25(a). Regulatory capital requirements exclude any supervisory adjustment applied by APRA in accordance with paragraph 41 of LPS 110.

[8] 'Charge' means a charge created in any way and includes a mortgage or an agreement to give or execute a charge or mortgage, whether upon demand or otherwise.

29. If policy benefits can be reduced in response to a fall in the value of an asset listed in paragraph 25, the asset does not have to be deducted from the capital base. However, the asset will be subject to a 100 per cent capital charge when applying the default risk stress under *Prudential Standard LPS 114 Capital Adequacy Asset Risk Charge*. This treatment can only be applied if:

    (a) the benefits under the policy are contractually linked to the performance of the asset;

    (b) the extent of the exposure to the asset is consistent with the stated investment objectives; and

    (c) there has been appropriate disclosure to policy owners of the risks to which they are exposed.

Regulatory adjustments to Additional Tier 1 capital

30. For the purpose of calculating its capital base, a life company must adjust its Additional Tier 1 capital by deducting all holdings of own Additional Tier 1 capital instruments.

Regulatory adjustments to Tier 2 capital

31. For the purpose of calculating its capital base, a life company must adjust its Tier 2 capital by deducting all holdings of own Tier 2 capital instruments.

Capital base of a statutory fund

32. The capital base of a statutory fund is the sum of its net assets**,** after all specified regulatory adjustments, and Tier 2 capital.

33. The Tier 2 capital of a statutory fund consists of instruments issued by the fund that meet the criteria for inclusion in Tier 2 capital as set out in Attachment C, less all holdings by the fund of own Tier 2 capital instruments.

34. A life company must ensure that, at all times:

    (a) the capital base, net of Tier 2 capital, of each statutory fund exceeds 80 per cent of the PCR of the fund; and

    (b) the capital base of each statutory fund exceeds the PCR of the fund.

    APRA may, in writing, set higher minimum requirements.

Capital base of a general fund

35. The capital base of a general fund is the net assets of the fund, after all specified regulatory adjustments.

36. A life company must ensure that, at all times, the capital base of the general fund exceeds the PCR of the fund.

Regulatory adjustments to the net assets of a statutory fund or general fund

37. The amount of net assets to be included in the capital base of a statutory fund or general fund of a life company must be calculated after making the following deductions:

    (a) goodwill and any other intangible assets, net of adjustments to profit or loss, reflecting any changes arising from impairment of goodwill[9];

    (b) deferred tax assets net of deferred tax liabilities[10];

    (c) any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which the life company is an employer-sponsor, unless otherwise approved, in writing, by APRA. Any excluded surplus must reverse any associated deferred tax liability from net assets;

    (d) any deficit in a defined benefit superannuation fund of which the life company is an employer-sponsor and that is not already reflected in net assets;

    (e) all holdings of own capital instruments;

    (f) unrealised fair value gains (or, where applicable, adding back unrealised fair value losses) arising from changes in a life company's or a fund's own creditworthiness;

    (g) all reinsurance assets[11] (if positive) reported in relation to each reinsurance arrangement that, subject to a 6 month grace period from risk inception, does not comprise an executed and legally binding contract;

    (h) the component of an investment in a subsidiary, associate or joint venture that is required to meet regulatory capital requirements of that subsidiary, associate or joint venture[12];

    (i) assets that are under a fixed or floating charge[13] or other security, to the extent of the indebtedness secured on those assets;

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[9] This includes that component of investments in controlled entities which represents goodwill and any other intangible assets (i.e. current value less value of identifiable net tangible assets).

[10] Where the amount of deferred tax liabilities exceeds the amount of deferred tax assets, the excess cannot be added to net assets (i.e. the net deduction is zero). Deferred tax assets and liabilities include any tax effects that would result from adjustments to policy liabilities. This item excludes any amounts associated with surpluses in any life company employer-sponsored superannuation funds.

[11] For the purposes of this Prudential Standard, 'reinsurance assets' refers to reinsurance assets net of doubtful debts.

[12] This only applies to the remaining component of the investment after intangible amounts have been deducted from the net assets as specified in paragraph 37(a). Regulatory capital requirements exclude any supervisory adjustment applied by APRA in accordance with paragraph 41 of LPS 110.

[13] 'Charge' means a charge created in any way and includes a mortgage or an agreement to give or execute a charge or mortgage, whether upon demand or otherwise.

(j) the difference between the adjusted policy liabilities and the policy liabilities disclosed in the statutory accounts together with any tax effects that would result from these adjustments. This difference can be positive or negative. Policy liabilities must be net of reinsurance. The method of determining the adjusted policy liabilities is specified in Attachment D;

(k) the difference between fair value and reported value of assets. This deduction can be a negative amount if fair value exceeds reported value;

(l) for a friendly society benefit fund, unallocated surplus that cannot be transferred to the management fund; and

(m) for a friendly society management fund, seed capital that is a receivable from a benefit fund.

38. For the purposes of paragraphs 37(a) and 37(h), deductions only need to be made in respect of entities that are subject to prudential capital requirements, or that are operationally dependent or undertake insurance-related business, including brokers, agents, servicing or management companies.

39. In determining the deduction for deferred tax assets net of deferred tax liabilities, a life company may assume that tax benefits in one fund can be offset against deferred tax liabilities in another statutory fund or the general fund, subject to the offset only being used once in the calculation of the capital base for both funds. Deferred tax assets can only be netted against deferred tax liabilities where the tax assets and tax liabilities are levied by the same authority and the authority allows netting when the taxes are paid.

40. For the purposes of paragraph 37(c), a life company may make representations to APRA to include a surplus as an asset (and hence include the surplus in net assets) where the life company that is the employer-sponsor is able to demonstrate unequivocal and unrestricted access to a fund surplus in a timely manner. Where APRA is satisfied regarding such access, a life company may include the surplus in a fund's assets. This surplus will no longer be required to be deducted from net assets.

41. If policy benefits can be reduced in response to a fall in the value of an asset listed in paragraph 37, the asset does not have to be deducted from the net assets. However, the asset will be subject to a 100 per cent capital charge when applying the default risk stress under *Prudential Standard LPS 114 Capital Adequacy Asset Risk Charge*. This treatment can only be applied if:

(a) the benefits under the policy are contractually linked to the performance of the asset;

(b) the extent of the exposure to the asset is consistent with the stated investment objectives; and

(c) there has been appropriate disclosure to policy owners of the risks to which they are exposed.

42. For a friendly society benefit fund, **seed capital** may be added to the net assets of the fund.

Use of fair values

43. Where APRA considers that fair values are not prudent or reliable, APRA may, in writing, require a life company to make adjustments to the fair values of its assets and/or liabilities, or to hold higher levels of capital.

Notification requirements

44. A life company must inform APRA of any breach or prospective breach of the minimum requirements specified in paragraphs 11, 34 and 36. The notice must include remedial actions taken or planned to be taken to deal with the breach.

Adjustments and exclusions

45. APRA may, by notice in writing to a life company, adjust or exclude a specific requirement in this Prudential Standard in relation to that life company.

Transition

46. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard up until 31 December 2014.

Attachment A

Criteria for classification as ordinary shares for regulatory capital purposes

[This section will be replaced after the draft standards for ADIs are released.]

The criteria for classification as ordinary shares for regulatory capital purposes are:

1. Represents the most subordinated claim in liquidation of the life company.

2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The life company does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled and the statutory or contractual terms do not provide any feature which might give rise to such an expectation.

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid-in at issuance and is not subject to a contractual cap (except to the extent that an insurer is unable to pay distributions that exceed the level of distributable items).

6. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.

7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur.[14] Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.

9. The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.

10. The paid-in amount is classified as equity under the relevant accounting standards.

[14] In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by ordinary shares.

11. It is directly issued and paid-in and the life company cannot directly or indirectly have funded the purchase of the instrument.

12. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity[15] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

13. It is only issued with the approval of the owners of the issuing life company, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

14. It is clearly and separately disclosed on the life company's balance sheet.

[15] A related entity can include a parent company, a sister company, a subsidiary or any other affiliate.

Attachment B

Criteria for inclusion in Additional Tier 1 capital

[This section will be replaced after the draft standards for ADIs are released.]

1. The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.
2. The paid-in amount is classified as equity under the relevant accounting standards.
3. Issued and paid-in.
4. Subordinated to policy owners, creditors and subordinated debt of the life company.
5. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim as against the life company's creditors' claims.
6. Is perpetual (i.e. there is no maturity date and there are no step-ups or other incentives to redeem).
7. May be callable at the initiative of the issuer only after a minimum of five years:

   (a) to exercise a call option a life company must receive prior APRA approval; and

   (b) a life company must not do anything which creates an expectation that the call will be exercised; and

   (c) a life company must not exercise a call unless:

      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the life company; or

      (ii) the life company demonstrates that its capital position is well above its PCR after the call option is exercised.

8. Any repayment of principal (e.g. through repurchase or redemption) must be approved beforehand by APRA and life companies should not assume or create market expectations that APRA's approval will be given. Replacement issues can be concurrent with but not after the instrument is called.

9. Dividend discretion:

   (a) the life company must have full discretion at all times to cancel distributions/payments[16];

   (b) cancellation of discretionary payments must not be an event of default;

   (c) life companies must have full access to cancelled payments to meet obligations as they fall due; and

   (d) cancellation of distributions/payments must not impose restrictions on the life company except in relation to distributions to ordinary shareholders.

10. Dividends must be paid out of distributable items.

11. The instrument cannot have a credit sensitive dividend feature (i.e. a dividend that is reset periodically based in whole or in part on the life company's credit standing).

12. The instrument must contain a provision for the instrument to be written-off upon the occurrence of a trigger event. The trigger event is the earlier of:

    (a) a decision that a write-off, without which the insurer will become non-viable, is necessary, as determined by APRA; and

    (b) the decision to make a public sector injection of capital, or equivalent support, without which the insurer will become non-viable, as determined by APRA.

    As an alternative to write-off, insurers may elect to include a provision providing for conversion of the instrument into listed ordinary shares upon the occurrence of the trigger event.

13. Neither the life company nor a related party over which the life company exercises control or significant influence can have purchased the instrument, and the life company cannot have funded (directly or indirectly) the purchase of the instrument.

14. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

[16] A consequence of full discretion at all times to cancel distributions/payments is that 'dividend pushers' are prohibited. An instrument with a dividend pusher obliges the issuing life company to make a dividend payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term 'cancel distributions/payments' means extinguish these payments. It does not permit features that require the life company to make distributions/payments in kind.

15. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a **Special Purpose Vehicle**), proceeds must be immediately available without limitation to an operating entity[17] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

[17] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Attachment C

Criteria for inclusion in Tier 2 capital

[This section will be replaced after the draft standards for ADIs are released.]

1. Issued and paid-in.

2. Subordinated to policy owners and creditors of a particular statutory fund.

3. Classified as a liability of a particular statutory fund under the relevant accounting standards.

4. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim as against the claims of policy owners and creditors of the statutory fund.

5. Will only qualify if:

   (a) minimum original maturity of at least five years; and

   (b) there are no step-ups or other incentives to redeem; and

   [Note: The amount included in the capital base in the remaining five years before maturity must be amortised on a straight line basis]

6. May be callable at the initiative of the issuer only after a minimum of five years:

   (a) to exercise a call option a life company must receive prior APRA approval;

   (b) a life company must not promote the instrument on the basis that the call will be exercised[18]; and

   (c) a life company must not exercise a call unless:

      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the statutory fund[19]; or

      (ii) the life company demonstrates that the capital position of the statutory fund is well above its PCR after the call option is exercised.

7. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

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[18] An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the life company does not do anything that creates an expectation that the call will be exercised at this point.

[19] Replacement issues can be concurrent with but not after the instrument is called.

8. The instrument cannot have a credit sensitive interest feature (i.e. a coupon that is reset periodically based in whole or in part on the life company's credit standing).

9. The instrument must contain a provision for the instrument to be written-off upon the occurrence of a trigger event. The trigger event is the earlier of:

   (a) a decision that a write-off, without which the insurer will become non-viable, is necessary, as determined by APRA; and

   (b) the decision to make a public sector injection of capital, or equivalent support, without which the insurer will become non-viable, as determined by APRA.

   As an alternative to write-off, insurers may elect to include a provision providing for conversion of the instrument into listed ordinary shares upon the occurrence of the trigger event.

10. Neither the life company nor a related party over which the life company exercises control or significant influence can have purchased the instrument, and the life company cannot have funded (directly or indirectly) the purchase of the instrument.

11. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a Special Purpose Vehicle), proceeds must be immediately available without limitation to an operating entity[20] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.

[20] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Attachment D

Definition of Adjusted Policy Liabilities

Non-participating benefits

1. For each statutory fund, the adjusted policy liabilities for **non-participating benefits** without entitlement to **discretionary additions** are the greater of:

   (a) the total **risk-free best estimate liability** (RFBEL) for all policies; and

   (b) the total **termination values** for all policies.

2. For each statutory fund, the adjusted policy liabilities for non-participating benefits with entitlement to discretionary additions are the greater of:

   (a) the total RFBEL for all policies; and

   (b) the total termination values plus, if it is greater than zero, the **investment fluctuation reserve** (IFR).

   The 'greater of' must be determined at sub-group level if the policy benefits for a sub-group of policies are determined by reference to the performance of particular assets that the life company has allocated to the liabilities for that sub-group.

3. The adjusted policy liabilities must be increased if the amount determined using the formula above would be insufficient to meet all guarantees and obligations implied by the promotional material of the company, and policy owners' reasonable benefit expectations based on past company practice.

Definition of RFBEL

4. For both **life insurance contracts** and **life investment contracts**, the RFBEL is determined by using the methods used to determine the **best estimate liability**, as specified in section 5 of *Prudential Standard LPS 1.04 Valuation of Policy Liabilities,* but with the gross investment yield and gross discount rate set equal to the **risk-free discount rate (capital standards)** plus illiquidity premium.

5. An illiquidity premium may only be added to the risk-free discount rate for policies that are:

   (a) Immediate life annuities;

   (b) Immediate term certain annuities;

   (c) **Fixed term/rate business**; and

   (d) **Funeral bond business**.

6. If an illiquidity premium is added to the risk-free discount rate for a policy, the adjusted policy liability must not be less than the **minimum termination value** for that policy.

7. *[Insert paragraph describing the method for determining the illiquidity premium].*

8. For business that is taxed on profits, the RFBEL must exclude the value of future tax payments. Business is considered to be taxed on profits if an increase in policy liabilities would be deducted from the company's taxable income.

9. The RFBEL must be determined net of expected reinsurance recoveries.

Definition of termination value

10. The termination value of a policy, before adjustments, is either:

    (a) the amount that would be paid in the event of voluntary termination; or

    (b) where no amount would be paid, the discounted present value of the unexpired risks, future payments and/or contractual premium refunds;

    The termination value of a policy must be adjusted, if necessary, so that it satisfies the conditions specified in the following paragraphs.

11. The termination value for a policy cannot be less than the minimum termination value. Deductions may be made for expected reinsurance recoveries.

12. For an investment linked policy, the unit prices used for determining the termination value must be consistent with the fair values of the assets backing the policy.

13. If there are unsettled insurance claims (whether reported or not), the best estimate of the amount potentially payable, taking appropriate account of claims settlement costs and reinsurance recoveries, is to be counted as the termination value.

14. If the company's obligation to pay a termination value under the policy involves:

    (a) deferred payments; or

    (b) payment by instalments over a period;

    the termination value is the value of those payments.

15. The discount rate used for the purpose of paragraphs 13 and 14 must be the risk-free discount rate. An illiquidity premium may be added to the risk-free discount rate for policies satisfying the criteria listed in paragraph 5.

16. If the company's obligation under a policy involves payment of an income stream (e.g. immediate annuities and disability claims in course of payment) or if the policy is fixed term/rate business or funeral bond business, the termination value cannot be less than the RFBEL.

Participating benefits

17. For each statutory fund, the adjusted policy liabilities for **participating benefits** are the greater of:

    (a) the total **participating policy liabilities** (PPL) for all policies, where PPL = RFBEL + max{RFVFB + PRP[21], 0}; and

    (b) the total termination values for all policies, increased if necessary so that, if all termination values were paid immediately, the remaining PRP would not be greater than zero.

    Where:

    (i) RFBEL is defined in the same way as for non-participating benefits;

    (ii) RFVFB is the value of future **bonuses** calculated at the rate supported by the net policy liability using the **best estimate assumptions** but with the gross investment yield and discount rate set equal to the risk-free discount rate (capital standards);

    (iii) PRP is policy owners' retained profits;

    (iv) Termination values are defined in the same way as for non-participating benefits.

18. All amounts must include allowance for bonuses declared as at the reporting date.

19. The adjusted liability must be increased if the amount determined using the formula above would be insufficient to meet all guarantees and obligations implied by the promotional material of the company, and policy owners' reasonable benefit expectations based on past company practice.

20. The adjusted policy liabilities must not be less than the mean of the distribution of the potential liability outcomes. If the benefits being valued contain options that may potentially be exercised against the company, or the potential liability outcomes have an adverse asymmetrical distribution, then the adjusted liability must include an appropriate value in respect of those options and/or asymmetries. For this purpose, the benefits being valued must include the distribution of all policy owners' retained profits.

[21] or unallocated benefit fund reserves in the case of friendly societies.

Friendly societies

21. Friendly society benefits are neither participating nor non-participating. The adjusted policy liabilities for benefit funds where there is a provision for distribution of unallocated surpluses to policy owners are to be valued as if they were participating. The adjusted policy liabilities for benefit funds where is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating.